

## Good MornING Asia - 7 February 2018

Appreciating Chinese yuan supports forecast of continued rise in China's foreign exchange reserves. The solid consensus of no change to Indian central bank policy today suggests no light at the end of the tunnel for the sovereign bond market. Upside inflation surprise raises the likelihood of Philippines central bank policy tightening soon

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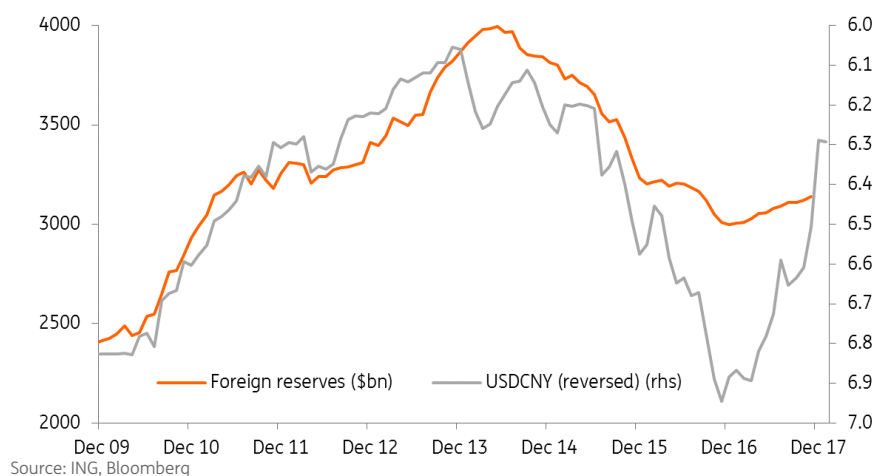
# Foreign reserves pile up by strong yuan

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Source: Shutterstock

## China foreign reserves build up with strong yuan



## Foreign reserves would keep rising, thanks to currency appreciation

We expect foreign reserves to rise to \$3165.0bn in January 2018 from December's \$3139.9bn. The increase should not be a surprise given the fast appreciation of the yuan against the dollar by 3.46% in the month. We expect more capital inflows attracted by the appreciating yuan.

The argument is even stronger if we look at the foreign reserves from a valuation perspective, as the British pound rose 5.1% and the euro rose 3.35% in January 2018. That implies investment gains of the foreign reserves simply by currency appreciation as the foreign reserves are denominated in dollars.

## PBoC continues to worry about capital outflows, but not so for US

PBoC continues to worry about capital outflows as we do not see any relaxation of restrictions on outward investments by corporates.

However, we are not particularly worried about capital outflows, except from the fact that there would be capital outflow needs from the anti-corruption campaign in the Mainland.

We have started monitoring to see if the capital flow begins to change direction. Put simply, we believe that with expectations of a strong yuan more money would be coming into China for direct investments and also for portfolio investments.

Some of this could be hot money from the regulators's perspective. And it would be interesting to see how regulators react.

Would the regulator stem hot money inflows through currency intervention in the market or through window guidance? These two would yield different results.

The impact from the first measure (the steps usually hurt the long yuan investors and then after a while hurt the short yuan investors) would be more short-term but those actions could rock the market for a couple of months.

The effect from window guidance could be mild depending on the scale of expected hot money inflows but window guidance usually lasts longer, and is less predictable from the degree of tightness of the measures.

## The sell-off of US Treasuries has not affected the Chinese market so far

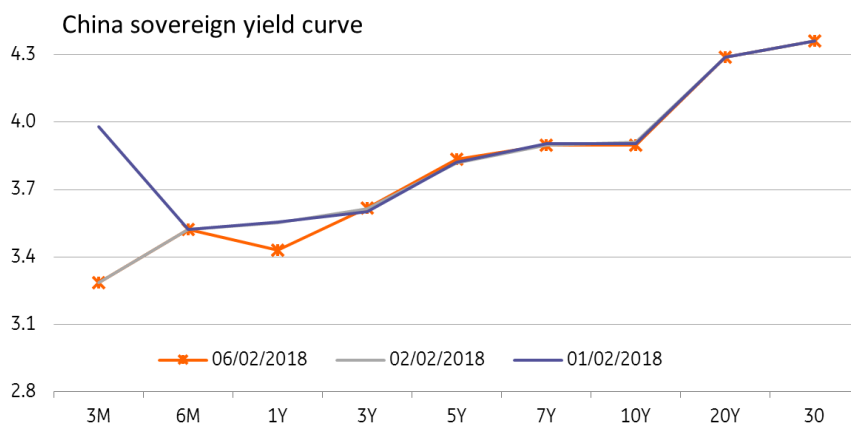
The dollar rises when the market has started to sell off US Treasuries. Though this affects exchange rates globally, it has little impact so far in the Mainland onshore bond market. Sovereign yields have not moved much.

This should not be explained by the PBoC's liquidity injection, because that aims to smooth short-term rates rather than sovereign yields.

Money freed up from the sale of US Treasuries needs to be reinvested somewhere in the world, and

we would keep an eye on the China sovereign and quasi-sovereigns for changes in demand.

## Recent sell-off of US Treasuries do not have an impact on the China sovereign curve



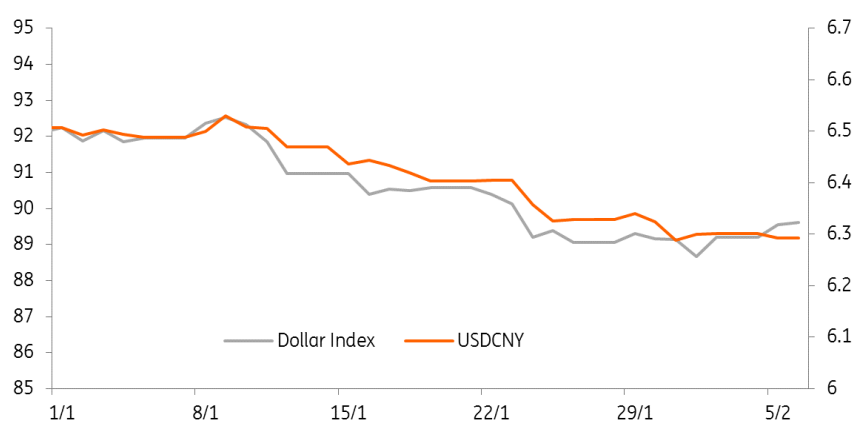
Source: ING, Bloomberg

## We keep our forecast of USD/CNY at 6.10 by the end of 2018

Despite the recent rise of the dollar trend, we believe that it is short-lived. Though we expect that the Fed to hike rates in March, we do expect the PBoC to follow the Fed with a slight move of 5bp as interest rates in China are already under upward pressure during the financial deleveraging reform.

Therefore we keep our forecasts of USD/CNY at 6.10 by the end of 2018.

## Yuan would keep its strong trend though there are times of reversals from dollar hiccups



Source: ING, Bloomberg

## Will India's central bank arrest the bond market selloff?

The Reserve Bank of India's solid consensus forecast to keep monetary policy on hold offers no hope



# 6%

RBI repurchase rate

Consensus forecast is no change

### Unanimous consensus for on-hold RBI policy

The Reserve Bank of India (RBI) holds its monetary policy meeting on Wednesday, February 7. This is another significant policy event for local markets after last week's Federal Budget. The budget for fiscal year 2018-19 (April-March) failed to arrest the selling pressure on government bonds underway since August last year. And the unanimous consensus behind an on-hold RBI rate policy decision offers no hope either.



**3.5%** FY2017-18 fiscal deficit  
% of GDP

Worse than expected

## Halted fiscal consolidation

The upward revision to the government's budget deficit estimate for FY2017-18 to 3.5% of GDP from the original plan of 3.2% together with the likelihood of another deficit overrun in FY2018-19 – the election year – above the 3.3% plan, has almost halted the consolidation of public finances toward the 3% deficit target, the timing for which is now pushed out to FY2020-21. The announcement spooked the bond market further, sending yields on the 10-year bond up by 18 basis points to an almost two-year high of 7.6%.

## RBI policy dilemma

The increase in the government borrowing requirement to finance wider budget deficits complicates the RBI's policymaking while containing inflation remains the primary goal of monetary policy.

At 5.2% year-over-year in December, consumer price inflation has surged past the RBI's 4.2-4.6% forecast for the second half of FY2017-18. While we expect inflation to be sticky downward (resistant to moving down) going forward, the risk of it breaching above the RBI's 2%-6% medium-term policy target cannot be ruled out. The budget announcement of hikes in the minimum support price for agriculture produce will sustain upward pressure on food prices- almost half of the CPI basket. The pass-through of rising global oil prices to domestic fuel prices is an additional factor. And now we have rising inflation expectations from fiscal slippages making the matter worse.

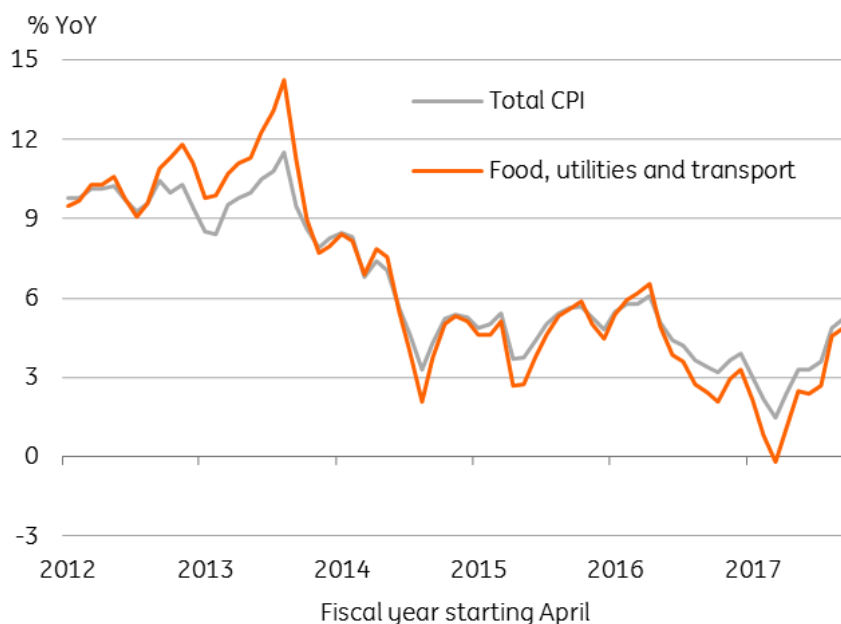
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### *Raising interest rates isn't an option for the RBI*

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Still, higher interest rates not only worsen the market for government borrowing, they also hurt demand for already-weak private investment. What's more, tighter policy leads to the deterioration of banks' balance sheets, especially those of public sector banks with a high level of non-performing assets. Higher public spending crowding out private spending will be a further hit to the economy's growth prospects. This is not a favourable economic backdrop for the 8% GDP growth that the Modi administration is dreaming about to boost its chances for re-election next year. The central bank can't help to achieve it either by easing monetary policy anytime soon.

## Rising consumer price inflation



Source: Bloomberg, ING

### No near-term respite from selloff in bonds and currency

We reiterate our forecast of no change to the RBI rate policy throughout 2018, which is also the broad consensus view. We expect continued weakening pressure on government bonds and the Indian rupee (INR) this year. We revise our end-2018 USD/INR forecast from 64.5 to 65.0 (spot 64.3, consensus 64.5).

## The market selloff



Source: Bloomberg, ING

## Philippines: Monetary policy tightening could be soon due to upside inflation surprise

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# 4%

January headline inflation

Upside surprise also with core inflation of 3.9%

Worse than expected

### BSP would need to anchor inflation expectations while ensuring the inflation target is met

January's headline and core inflation rates delivered a major blow to inflation expectations. The government reported headline and core inflation rates of 4% and 3.9%, respectively. These are worse than the consensus forecasts of 3.5% and 3.2%, respectively. The data is also at the



upper end of the BSP's headline inflation forecast range of 3.5% to 4%. Price pressures are likely to persist for most of this year, which would see higher inflation forecasts. We now expect 2018 inflation to average at least 4%, which is the upper end of the BSP's inflation target range of 2% to 4%. These developments also change monetary policy expectations. We expect a more hawkish BSP at this Thursday's meeting to prepare the way for a rate hike in March from our previous forecast of a May rate hike. We also expect BSP to hike policy rates three times this year from our previous two-rate hike forecast. We believe that BSP needs to act in order to anchor inflation expectations and ensure the achievement of its inflation target.

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